Fiscal Analysis:

Retirement Costs Consuming an Increasing Proportion of the General Fund

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A Report by

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Introduction

The Mayor and City Council recently adopted partial solutions to address a projected $179 million deficit for FY 2011. While the proactive nature of this decision is commendable, the heavy reliance on one-time fixes and lack of sufficient concrete action toward structurally reforming the city's financial problems is a significant cause for concern.

Unfortunately, revenue projections have worsened since the release of the Five Year Outlook, and the June 30, 2009 actuarial valuation by the SDCERS actuary requires the city to make a higher pension payment for FY 2011 than anticipated in the adopted 18-month budget.

Looking an additional year forward, the Independent Budget Analyst has noted that the impact of the most recent revenue projections "could leave a deficit ranging from $77.0 million to $106.0 million in FY 2012."

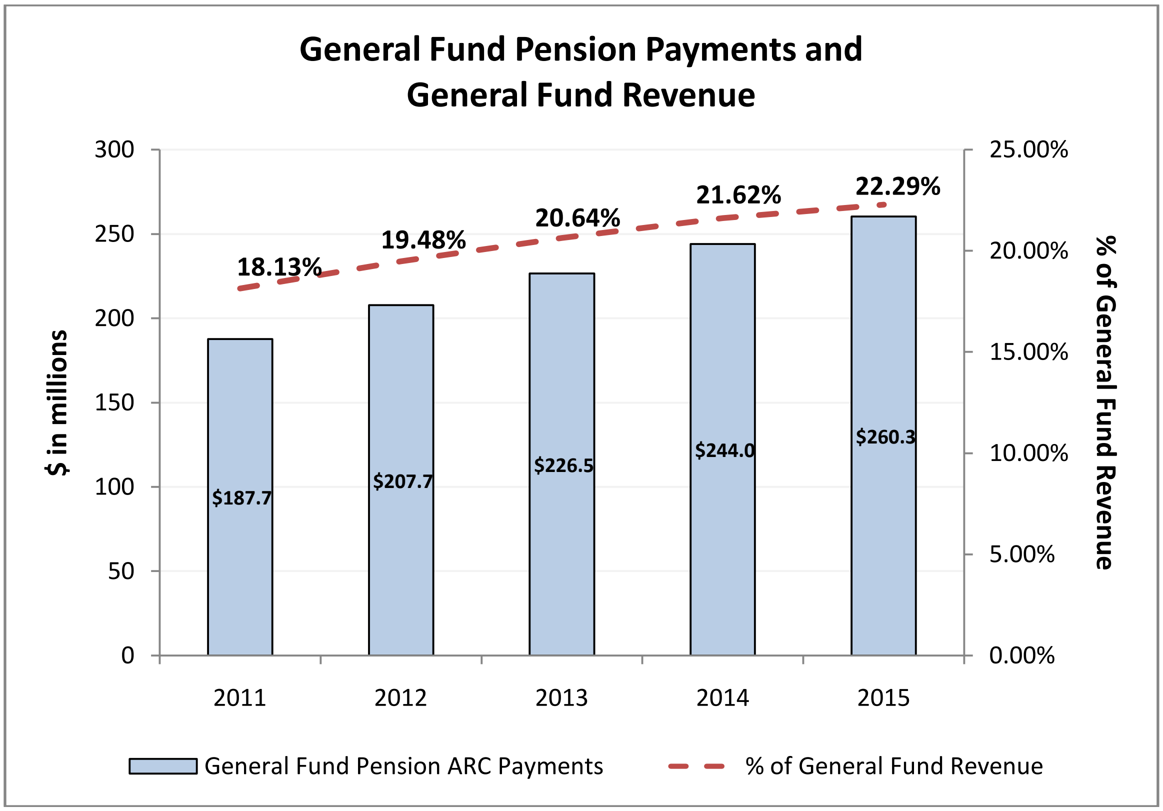
As a result, the Mayor and Council will need to take further action to balance both the FY 2010 and FY 2011 budgets on top of the actions taken in December. Furthermore, the continued reliance on one-time fixes suggests that deeper cuts to operating expenses will be necessary in order to bring these budgets into balance, as the remaining one-time options are decidedly finite.

This report examines the projected relationship between General Fund revenues and annual pension and retiree health liabilities. Unfortunately, the data provides the overwhelming conclusion that the financial day of reckoning is quickly approaching for the city of San Diego. The Mayor and Council have created a quickly closing window of opportunity to address these liabilities, but must take further and decisive action quickly in order to alter the city's financial outlook.

In no uncertain terms, the city's liabilities associated with pension and retiree health care must be reduced if the city is to successfully resolve its perpetual financial crisis.

Liability Outlook – Pension and Retiree Health Care

The recently released June 30, 2009 actuarial valuation for the city's pension system indicates that the system has an Unfunded Actuarial Liability (UAL) of $2.11 billion, with a funding ratio of 66.5%. At a citywide value of $231.7 million (General Fund portion of approximately $187.7 million), the FY 2011 Annual Required Contribution (ARC) will be slightly higher than indicated by the forecast in August, meaning the budgeted savings due to anticipated actuarial gains failed to materialize. The graph below shows the percentage of General Fund revenue projected to be consumed by the city's pension payment over the next five fiscal years.



Data Sources:
- <u>General Fund Revenue</u>: IBA Report 09-90, pg. 32
- <u>Pension ARC, FY 2011</u>: SDCERS June 30, 2009 Actuarial Valuation (81% of citywide ARC value used to produce General Fund portion, per FY 2010 Budget and Five Year Outlook methodology)
- <u>Pension ARC, FY 2012 – FY 2015</u>: ***<u>(NOTE: Estimated Savings from New Pension Plan Included)</u>*** Applies 5 Year Outlook Projected Savings to Cheiron Presentation to SDCERS Board of Administration, January 22, 2010 (81% of citywide ARC values used to produce General Fund portion; per FY 2010 Budget and Five Year Outlook)

While the savings from the pension reforms already achieved for new hires after July 1, 2009 has not been included in the actuarial long-range forecast provided at the January 22, 2010 SDCERS Board meeting, the Five Year Outlook does provide values of projected savings. As indicated above, these savings are built into the FY 2012 – FY 2015 ARC estimates provided by Cheiron and used throughout this document.

The following table provides the savings necessary to maintain a constant proportional relationship between General Fund revenue and the General Fund portion of the pension ARC payment over the next five fiscal years.

Derivation of Savings Needed to Hold Pension Payment at FY 2011 Proportion of General Fund (GF) Revenue (in millions of $)							
Fiscal Year	Projected GF Revenue	Projected GF Pension ARC[1]	GF Pension ARC as % of GF	"Constant Proportion" GF ARC	Needed Savings to Maintain FY 2011 GF Proportion	Projected GF Savings in 5 Year Outlook	Projected Savings Shortfall for "Constant Proportion"
2011	1034.9	187.7	18.13%	N/A	N/A	N/A	N/A
2012	1066.6	209.6	19.65%	193.4	16.2	1.9	14.3
2013	1097.4	229.1	20.88%	199.0	30.1	2.6	27.5
2014	1128.4	247.3	21.92%	204.6	42.7	3.3	39.4
2015	1167.8	264.5	22.65%	211.8	52.7	4.2	48.5

Given that the projected savings in the Five Year Outlook[2] are significantly less than the required savings to maintain a constant proportional relationship, the data strongly suggests that an increasing portion of the city's General Fund is likely to be consumed by the pension ARC payment without further action to decrease the liability.

Retiree Health Care

The city is compelled by the City Charter to pay the ARC that SDCERS presents every year.[3] In contrast, the city is not legally compelled to make its full retiree medical ARC payment.

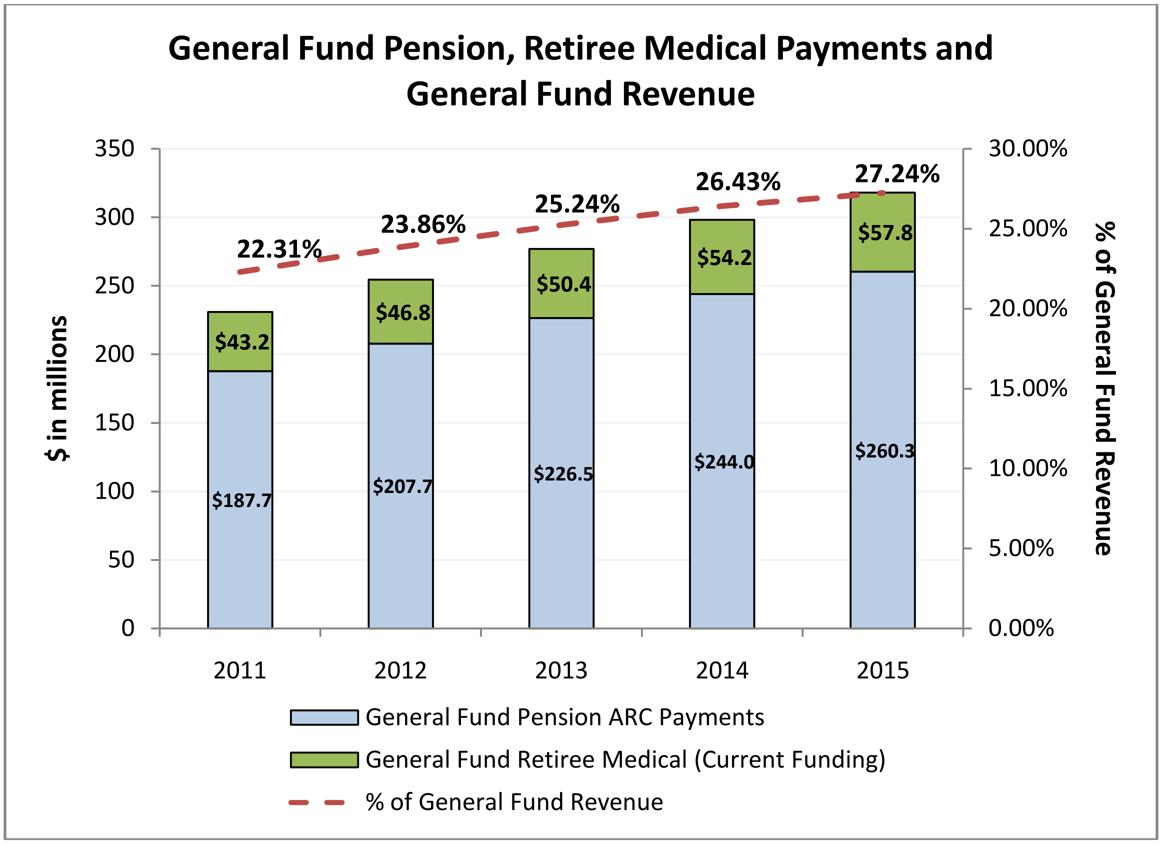
Legal and/or tax compliance requirements aside, consistently underfunding the retiree medical ARC has an impact similar to underfunding the city's pension liability: 1) the cost of benefits earned in the present is deferred to future taxpayers, 2) "[w]hen there is a deficit, it means that those assets are not in the Plan's investment pool where they would be generating investment earnings."[4]

The city's current funding strategy for retiree medical underfunds the ARC by approximately 50% in FY 2010 and 2011. The unfunded liability for retiree health care stands at $1.3 billion as of the June 30, 2009 valuation, with a funding ratio of 3%.

The current retiree health care funding policy consists of the PAYGO portion of retiree medical expenses and contributes an additional $25 million to pre-fund the CalPERS OPEB trust. Note that more comprehensive actuarial projections of the OPEB ARC and annual UAL under a variety of scenarios – in addition to the current funding policy and

[1] From January 22, 2010 presentation from Cheiron. Does NOT include savings from new plan.
[2] See page 25 of the FY 2011 – FY 2015 Five Year Financial Outlook
[3] See San Diego City Charter Section 143.
[4] City of San Diego Pension Reform Committee Final Report. September 15, 2004.

information provided in the current valuation - have been requested.[5] This data is forthcoming, according to city management.



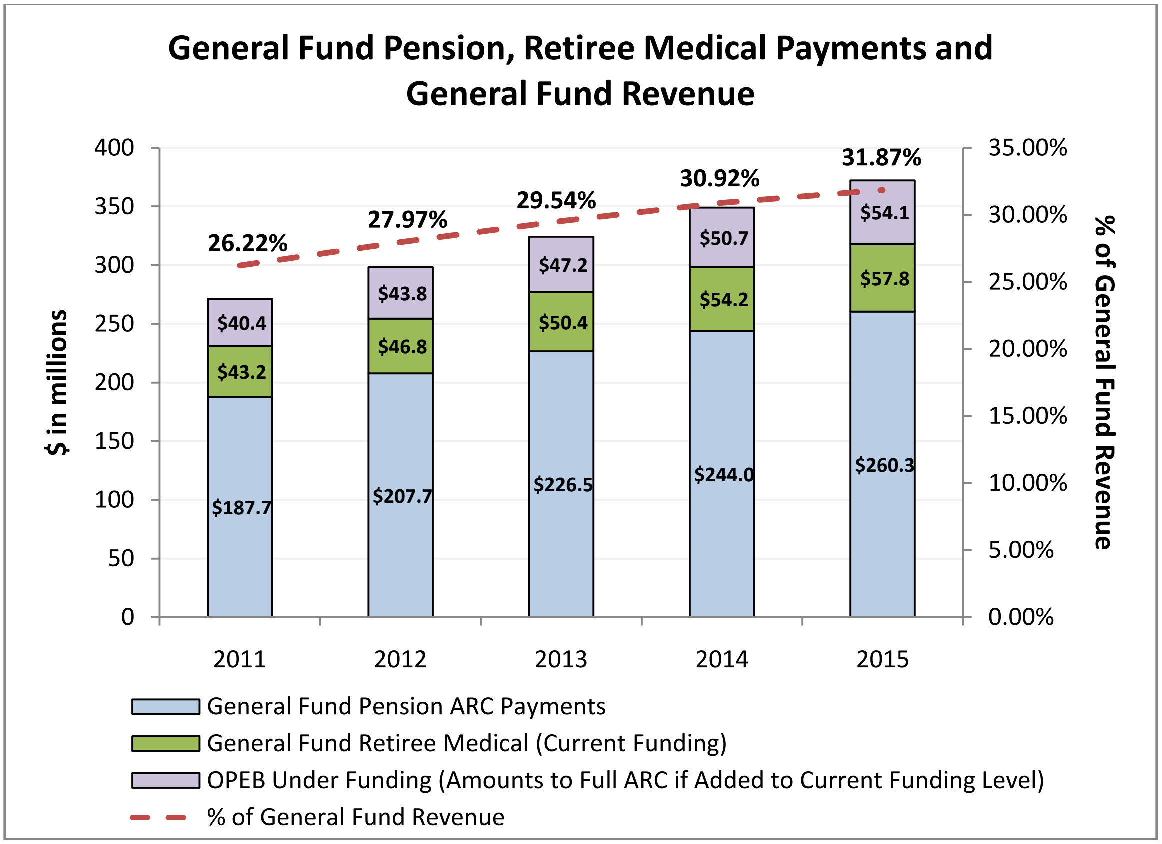
The chart[6] above combines planned funding levels of retiree health care with the previous pension graph. Note that by the third year of the Five Year Outlook, more than a quarter of all General Fund revenue is slated to be consumed by annual payments for pension and retiree health care.

While the above chart clearly displays the daunting financial strain the city faces as a result of these two liabilities, it is important to reiterate the impacts of the OPEB funding strategy in the chart. Perhaps more sobering than the relationship depicted in the chart above is that the retiree medical funding level represents an annual citywide underfunding of approximately 50%.

The chart below displays the percentage of General Fund revenue that would be consumed by pension and retiree health care costs alone if the city were fully funding retiree health care.

[5] See Council District 5 October 21, 2009 memorandum entitled "Comprehensive Outlook on OPEB Liability."

[6] Retiree Medical Data from Five Year Outlook; for Revenue and Pension ARC estimates, see "Data Sources" description in previous chart.



Data Sources:
- General Fund Revenue: IBA Report 09-90, pg. 32
- Pension ARCs: See previous charts
- Retiree Medical Funding: Five Year Financial Outlook
- Retiree Medical Underfunding (FY 2011): Five Year Financial Outlook
- Retiree Medical Underfunding (FY 2012 – FY 2015): Assumes proportional relationship between funding and underfunding equivalent to that given for FY 2011 in the Five Year Outlook.

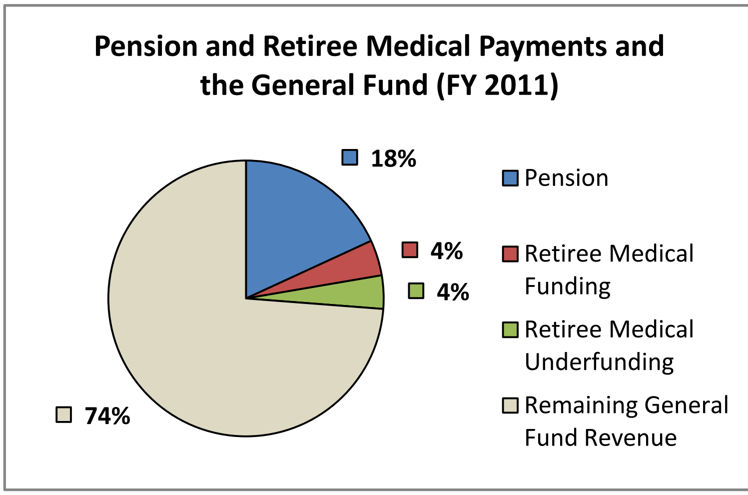
(ARC / Funding Level = 1.94 in each fiscal year.)

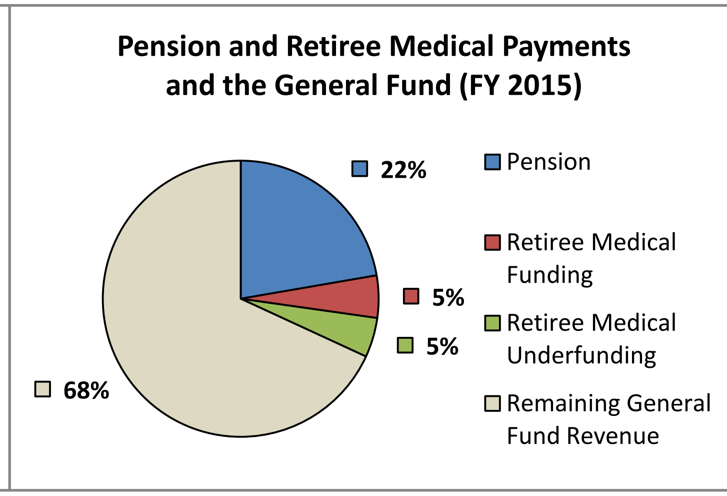
Note that these estimates are in lieu of the actuarial work discussed in Footnote 5.

While set as a goal in previous Outlooks, full payment of the OPEB liability has not been funded in the budget, nor scored into the reported deficit. While the city anticipates savings from negotiations following a joint-study with the city's employee bargaining units, the significant size of the retiree health care liability depicted above underscores the importance of successfully reducing this liability through negotiations.

This steady trend of decreasing discretionary revenue for the city suggests that even after resolving the current budget deficit for FY 2010 and FY 2011 (presuming more budget balancing actions are taken in the next 18-month period), the city will face annually increasing budgetary pressure from its pension and retiree medical liabilities in FY 2012 and beyond.

As an alternative graphical perspective of the data from the previous graphs, consider the following pie charts for the "bookend" years of the last Five Year Outlook, FY 2011 and FY 2015 below:





General Fund Revenue and Projected Annual Expenditure Data ($ in millions)

Fiscal Year	General Fund Revenue	GF Pension ARC	GF Retiree Medical Funding	GF Retiree Medical Underfunding	GF Retiree Medical ARC	Remaining GF Revenue	Annual % Change in Remaining Revenue	% GF Remaining
2011	1034.9	187.7	43.2	40.4	83.6	763.6	N/A	73.78%
2012	1066.6	207.7	46.8	43.8	90.6	768.3	0.61%	72.03%
2013	1097.4	226.5	50.4	47.2	97.6	773.3	0.65%	70.46%
2014	1128.4	244.0	54.2	50.7	104.9	779.5	0.80%	69.08%
2015	1167.8	260.3	57.8	54.1	111.9	795.6	2.07%	68.13%

Perhaps the most ominous information in the charts and table above is the projected amount of revenue remaining in the city's General Fund each year after paying for pension and retiree health liabilities. On a year-over-year basis, the city's remaining General Fund revenues are not projected to increase by even 1% until FY 2015, when a 2.07% year-over-year increase in remaining revenue is projected.

In 2004, the Pension Reform Committee Minority Report[7] noted the following:

> *What is most disturbing is the projected annual cost to the City to pay for the on-going costs of these promised retiree benefits and at the same time to pay off the accumulated "debt" from not having paid the full cost of these benefits in the past.*
>
> *At the city's current rate of partial payment of retiree costs, in FY '05 pension costs alone will represent 13.6% of the City's total general fund…*
>
> *…To illustrate the severity of the fiscal challenge to the City, and to focus on the key question of whether the City can truly afford these retirement benefit promises it has made, this full funding annual payment…would be a staggering **27%** of the total General Fund…This would*

[7] R.H. Vortmann's *Minority Report*, September 15, 2004.

represent over one quarter of the total General Fund just for retiree benefits! And this is before any city "pickup" of the employee's share of pension cost, which is the current practice.

…Very simply and critically, the City must address the basic question of whether it can afford these benefits…

If…the City concludes it cannot afford these benefits, the City needs to take immediate action to prevent the problem from growing, by reducing the cost of benefits for existing employees where allowable by law.

Notably, this same message contained in the Minority Report remains relevant more than 5 years later.

Unfortunately, the budgetary realities remain the same, if not worse: sufficiently funding its annual pension and retiree health care liabilities would consume more than one-quarter of the city's General Fund, and more than 30% of the General Fund by the end of the Five Year Outlook *before* accounting for other retirement benefits like "pickup" and SPSP ($5.2 million and $13.5 million General Fund costs, respectively).

Reforms to Liabilities Are Crucial to Restoring Financial Health

The structural burden that the city's pension and retiree health care liabilities place on the budget is enormous, and projected only to grow throughout the entire course of the Five Year Financial Outlook. Given this ominous outlook, the fact that the city has begun the development of a strategic plan to tackle its structural deficit in a comprehensive fashion is commendable.

However, the plan must be accompanied by decisive action in order to be effective. Reducing the city's liabilities associated with retirement benefits must be a key component to any budgetary reform efforts due to the sheer size of these liabilities. The coming months will be critical to solving the city's financial problems, and will require the dedicated efforts of the Mayor and City Council.